

Sales of "canned" computer software are taxable retail sales in Illinois whether purchased off the shelf or downloaded over the Internet. See 86 Ill. Adm. Code 130.1935. (This is a PLR).

November 2, 1999

Dear Ms. Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (see enclosed), is in response to your letter received September 16, 1999. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of the enclosed copy of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit nor involved in litigation concerning the issues that are the subject of this ruling request.

In your letter, you have stated and made inquiry as follows:

The taxpayer, COMPANY, respectfully requests a Private Letter Ruling from the Department regarding the taxability for Retailers' Occupation Tax purposes of its one-time prepaid software license fees and related monthly license and support fees.

**I. Name, Address and Taxpayer Identification Number:**

NAME/ADDRESS

**II. General Nature of Taxpayer s Business Activities:**

COMPANY sells computer systems which include computer hardware consisting of central processing units and peripheral equipment and licenses various industry-specific computer software applications to automobile, truck and motorcycle dealers. The separate software applications are standard (canned) applications which are offered to all clients and range from back-office accounting and inventory control applications to front-office showroom traffic tracking and vehicle financing applications. COMPANY offers approximately 50 of these standard prewritten software applications. On average, a large multi-franchise dealer licenses 20 applications while single-franchise dealers license 9 applications. COMPANY has approximately 29,000 clients located throughout the U.S., 1,100 of which are located within the State of Illinois.

**Fees Charged to Clients:**

Each of the approximately 50 software applications represents standard software offered universally to all clients. The average term of a software licensing agreement is five to seven years. For each software application licensed by the client, there is a one-time prepaid software license fee and also a monthly license

and support fee. The prepaid software license fees range from \$300 to \$3,000, depending on the software application selected, with an average prepaid software license fee of approximately \$900. For any single software application, the list price fee is the same from client to client since the software applications licensed are the same from client to client. The monthly license and support fee is a bundled charge which includes a monthly software license fee, telephone support services and upgrades to the software being licensed. This monthly license and support fee is **not optional** for the client.

### III. **Supporting Documents**

A copy of the COMPANY Master Services Agreement ('MSA') is attached for review – **Exhibit I**.

### IV. **Statement of Relevant Authorities:**

Based upon the above description of the taxpayer's software licensing activities, the taxpayer's Master Services Agreement ('MSA') and in conjunction with numerous inquiries raised by its Illinois client base, the taxpayer requests a ruling from the State of Illinois that COMPANY's prepaid software license fees and related monthly license and support fees are not exempt from taxation under Section 130.1935(a)(1).

Under Section 130.1935(a)(1), a license of software is not a taxable retail sale if:

- (A) it is evidenced by a written agreement signed by the licensor and the customer [**MSA Exhibit I**]
- (B) it restricts the customer's duplication and use of the software [**MSA Para. 8B**];
- (C) it prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) [**MSA Para. 6C and 8C**];
- (D) the vendor will provide another copy at minimal or no charge if the customer loses or damages the software; and
- (E) the customer must destroy or return all copies of the software to the vendor at the end of the license period [**MSA Para. 6D and 8C**].

A review of **Exhibit I**, the COMPANY Agreement, indicates that the Agreement contains provisions meeting the requirements of Section 130.1935(a)(1)(A), (B), (C) and (E), as indicated above. However, the Agreement does not contain provisions meeting the requirement of Section 130.1935(a)(1)(D) that the vendor

will provide another copy of software at minimal or no charge if the customer loses or damages the software. This provision is not stated in the Master Services Agreement and is currently not evidenced in the taxpayer's books and records. On occasion, the taxpayer has provided a duplicate copy of the software at no charge to the client. However, the taxpayer does not maintain a record of such replacements and cannot state definitively that clients have not been charged for the replacement of lost or damaged software.

Based upon the above and pursuant to the determination in Private Letter Ruling ST 99-0004-PLR (Jan. 12, 1999), the taxpayer continues to collect and remit Retailers' Occupation Tax on the prepaid software license fees and monthly license and support fees that it invoices to its Illinois clients. Also note that the taxpayer has consistently been audited by the State for Retailer's Occupation Tax purposes where the taxpayer's collection and remittance of such tax from its Illinois clients has been reviewed. [The following audits took place over the past several years: 1990 covering the period 7/87 – 12/89; 1992 covering the period 1/90 – 12/92; 1995 covering the period 1/93 – 12/95 and 1998 covering the period 1/96 – 8/98.]

Due to numerous inquiries received from the taxpayer's Illinois clients pertaining to the taxability of the prepaid software license fee and the related monthly license and support fee, however, the taxpayer requests a ruling from the Department of Revenue that the Illinois Retailers' Occupation Tax applies to:

- (1) The one-time prepaid license fee for its standard, canned software applications licensed to clients and
- (2) The monthly license and support fee which is a bundled charge which includes a monthly software license fee, telephone support and upgrades to the software application licensed.

In addition, if the taxpayer were to evidence in its books and records a policy of replacing lost or damaged software at minimal or no charge to the clients would such evidence impact the taxability of the prepaid software license fee and related monthly license and support fee for Illinois Retailers' Occupation Tax purposes? Also, if the State determines that the prepaid software license fee and related monthly license and support fee are exempt for Retailer's Occupation Tax purposes, what would be the effective date of nontaxability?

**V. Statement of Audit in Progress:**

The issue presented herein is not presently being audited by the Illinois Department of Revenue.

**VI. Statement as to Identical Issue:**

The taxpayer has not previously submitted a ruling request for this issue or a similar issue.

**VII. Statement of Contrary Authorities:**

The taxpayer is currently collecting and remitting the Illinois Retailers' Occupation Tax on its prepaid software license fees and its monthly license and support fees based upon its own interpretation of Section 130.1935(a)(1) and Private Letter Ruling ST 99-0004-PLR and consistent with prior Retailer's Occupation Tax audits conducted by the State.

Sales of "canned" computer software are taxable retail sales in Illinois whether purchased off the shelf or downloaded over the Internet. See the enclosed copy of 86 Ill. Adm. Code 130.1935. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See Section 130.1935(c). In determining whether software is "canned" or is "custom," please note that custom computer programs or software are prepared to the special order of the customer. The selection of pre-written or canned programs assembled by vendors into software packages does not constitute custom software unless real and substantial changes are made to the programs or creation of program interfacing logic. See Section 130.1935(c)(3).

Licenses of computer software, whether canned or custom, that meet all of the criteria provided in Section 130.1935(a)(1), will not be subject to Retailers' Occupation Tax nor will the transfer of the subsequent software updates related to that software. A license of software is not a taxable retail sale if:

- A) It is evidenced by a written agreement signed by the licensor and the customer;
- B) It restricts the customer's duplication and use of the software;
- C) It prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party);
- D) The vendor will provide another copy at minimal or no charge if the customer loses or damages the software; and
- E) The customer must destroy or return all copies of the software to the vendor at the end of the license period.

Review of the "Master Services Agreement" ("Agreement") attached to your letter indicates that the Agreement contains provisions meeting the requirements of Section 130.1935 (a)(1)(A), (B), (C) and (E). The Agreement does not contain provisions meeting the requirement of subsection (a)(1)(D) that the vendor will provide another copy of software at minimal or no charge if the customer loses or

damages the software. Please note that the Department has determined that this requirement is met, even absent explicit provisions in an agreement, if the vendors can produce evidence in their books and records showing that they have a policy of providing copies at minimal or no charge should customers lose or damage the software. You have indicated in your letter that your company does not maintain such a policy of providing copies of software at minimal or no cost if the customers lose or damage the software. Based upon this representation, the Agreement does not constitute a nontaxable license of the software described in the Agreement. Therefore, Retailers' Occupation Tax is incurred on the sale of this software and on all license fees imposed.

We understand your bundled mandatory monthly license and support fee includes a monthly software license fee, telephone support and upgrades to the software application. Generally, technical support services are exempt if they are separately stated from the selling price of canned software. See Section 130.1935(b). However, in this case, you assess a bundled fee that includes a monthly software license fee that is subject to tax. Therefore, the entire monthly license and support fee is subject to Retailers' Occupation Tax.

If your company starts to comply with 130.1935(a)(1)(D) and provides another copy of your software at minimal or no charge if your customers lose or damage the software, then this ruling may change.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules, or in the material facts recited in this ruling.

I hope this information is helpful. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Melanie A. Jarvis  
Associate Counsel

MAJ:msk  
Enc.